Internal Revenue Service

memorandum

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to: District Counsel, Cleveland C:CLE
Attn: Richard Bloom, Utility Industry Counsel

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for our comments regarding the effect of section 821(b)(3) of the Tax Reform Act of 1986 with regard to the unbilled revenue issue for taxable years beginning before August 16, 1986.

ISSUES

1. Should we continue to pursue the "unbilled revenue" issue in cases where the taxpayer is using the "bills issued" method and which contain "fragmented meter reading and billing cycles?" RIRA Nos. 0451.02-00; 0451.19-00

2. If the taxpayer offers to change its method of accounting to reporting revenues on the basis of a meter reading, should the "unbilled revenue" issue referred to in #1 above, be dropped? RIRA No. 7122.13-00

3. Where the taxpayer has previously agreed to change its method of accounting to report unbilled revenues and now files a claim or a new change of accounting application to report revenues on the basis of meter readings, should we approve it? RIRA No. 7122.02-00; 7122.11-00; 7122.13.00

4. Should we continue to raise the "budget billing" issue [see Revenue Ruling 72-114, 1972-1 C.B. 124] which involves the accrual of unbilled revenue from the last meter reading date to the end of the taxable year to the extent of the excess of budget billings for the year over the customers' meter reading billings? RIRA No. 0451.19-00

5. If the taxpayer has previously agreed to change its method of accounting to report budget billing revenues in accordance with Revenue Ruling 72-114, supra, and now files a claim or change in accounting application to eliminate these revenues, should we approve it based on the language in the Tax Reform Act [which deems the reporting of revenues on the basis of the period in which the customers' meters were read to be a proper method of accounting for Federal income tax purposes]? RIRA Nos. 7122.02-00; 7122.11-00; 7122.13-00

6. Should we continue to raise the "customer deposit" issue [see City Gas of Florida, TC Memo 1984-44]? Because the deposits represent advance payments for goods yet to be delivered, is the taxpayer not entitled to exclude them on the rationale that the advance payments relate to "unbilled revenues" and, thus, are not now required to be included in income except on the basis of a meter reading? RIRA Nos. 0451.13-01; 0451.13-03

7. If the taxpayer has previously agreed to change its method of accounting to report customer deposits in income as advance payments and now files a claim or a request for a change in accounting method to exclude these advance payments, should we allow it on the basis of the language in the Tax Reform Act [that reporting revenues on the basis of the period in which the customers' meters were read shall be deemed to be proper for Federal income tax purposes]? RIRA No. 7122.13-00

CONCLUSIONS

1. The Service should continue to pursue the "unbilled revenue" issue in those cases where the taxpayer is using the "bills issued" method and which contain "fragmented meter reading and billing cycles."

2. If a taxpayer offers to change its method of accounting to report revenues on the basis of a meter reading, in the context of issue 1 above, it is a policy decision whether to approve such a change. Approval of such a change, however, is not legally required.

3. We recommend not approving a claim or a change of accounting application to report revenues on the basis of meter readings where the taxpayer has previously agreed to change its method of accounting to report unbilled revenues.

4. If a taxpayer accrues income on the bills issued method, not the cycle meter reading method, the Service should continue to raise the "budget billing" issue to the extent that energy was delivered between a meter reading and the end of the year and payment was received.

5. We recommend not approving a claim or a change of accounting application which would eliminate the revenues which the taxpayer reported when it agreed to change its method of accounting to report budget billing in accordance with Revenue Ruling 72-114.

6. The Service should continue to raise the "customer deposit" issue.

7. The Service should not allow a taxpayer, who has previously agreed to change its method of accounting to report customer deposits in income as advance payments and now files a claim or a new request for a change in accounting method, to exclude these advance payments.

FACTS

Utility service taxpayers typically use three methods of computing taxable income: the meter reading and billing cycle method (also known as the cycle meter reading method or the meter reading method), the bills issued method, and strict accrual.

Under the meter reading method, a taxpayer includes in its gross income the charges to customers for energy consumed as reflected in meter readings falling within its taxable year. Gross income attributable to energy delivered to and used by customers in the taxpayer's taxable year but subsequent to the customer's last meter reading date in the taxpayer's taxable year is not generally included in the taxpayer's gross income until the following taxable year.

Under the bills issued method there is a fragmented meter reading and billing cycle at the end of the taxable year. A taxpayer includes in its gross income the charges to customers for energy consumed as reflected by the bills issued to its customers during its taxable year. Gross income attributable to energy delivered to and used by customers, even if reflected in a year-end meter reading, is not included in the taxpayer's gross income until the subsequent taxable year when the customer is billed.

Taxpayers using the strict accrual method recognize income at the time when all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be established with reasonable accuracy. Income is recognized during the taxable year in which the gas and electricity were furnished to the customer, and this results in a matching of related costs and revenues. This strict accrual method for utilities results in the recognition of unbilled revenue.

Utility companies also utilize a monthly budget-billing procedure which allows certain customers to pay an even monthly amount. The amount is derived by estimating in advance the cost of the customer's probable usage during the ten-month heating season and dividing that figure by ten to arrive at an equal monthly amount.

Many utility companies require their customers to pay a deposit which provides "security" that the customers will pay their bills. Usually these deposits are returned when the customer demonstrates that the utility bills will be timely paid or when service is terminated, whichever occurs first.

The Tax Reform Act of 1986 has standardized the method by which utility companies can compute taxable income. The legislation does not specifically address budget billing or customer deposits.

Section 821 of the Tax Reform Act of 1986, Pub.L. No. 99-514, added section 451(f) to the Internal Revenue Code and is effective for taxable years beginning after December 31, 1986. The statute provides that any income attributable to the sale or furnishing of utility services to customers shall be included in gross income not later than the taxable year in which such services are provided to such customers. Moreover, that section provides that the year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time the customer is billed (or may be billed) for such services.

However, section 821(b)(3) of the Act provides that if a taxpayer for any taxable year beginning before August 16, 1986, for purposes of Chapter 1 of the Internal Revenue Code of 1986 took into account income from services described in section 451(f) of such Code on the basis of the period in which customers' meters were read, then such treatment for such year shall be deemed to be proper. This provision in the law, thus effectively makes the meter reading and billing cycle method of

accounting a permissible method of accounting for taxable years beginning before August 16, 1986. The conference report, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-323 (1986) states that no inference is intended as to methods of accounting for utility services which take income into accounting on the basis of the date the customer is billed for utility services.

DISCUSSION

1. The Service should continue to pursue the "unbilled revenue" issue in those cases where the taxpayer is using the "bills issued" method and which contain "fragmented meter reading and billing cycles."

Congress in enacting section 451(f), determined that both the cycle meter reading and the bills issued methods of accounting result in a mismatching of income and expense because income is not recognized as it is earned. The Senate concluded that utilities using the accrual method of accounting should be required to recognize income at the time the utility services are provided. S. Rep. No. 313, 99th Cong., 2d Sess. 120-21 (1986).

Congress recognized that the cycle meter reading and bills issued methods of accounting do not properly recognize income at the time when all the events have occurred which establish the taxpayer's right to receive the income and the amount of income can be reasonably determined. Nevertheless the conferees stated they:

> [were] aware that the proper accounting for utility services is presently a matter of controversy between taxpayers and the Internal Revenue Service. In order to minimize disputes over prior taxable years the conference agreement provides that, for any taxable year beginning before August 16, 1986, a method of accounting which took into account income from the providing of utility services on the basis of the period in which the customers' meters were read shall be deemed to be proper for Federal income tax purposes. No inference is intended as to methods of accounting for utility services not described in the preceding sentence (e.g., a method of accounting which takes income into account on the basis of the date the customer is billed for utility services.)
> H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-323 (1986).

The conferees also recognized that the present law requires use of the "all events" test. Treas. Reg. § 1.446-1(c)(1)(ii) identifies this test as "Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy." But the conferees also recognized that the Internal Revenue Service had allowed the meter reading method as a variation of the all events test and strict accrual method if certain conditions were met. See Rev. Rul. 72-114, 1972-1 C.B. 124. Recent court decisions have expanded the cycle meter reading method by not requiring that the conditions be met and holding that the method clearly reflects income. See, e.g., Orange and Rockland Utilities, Inc. v. Commissioner, 86 T.C. 199 (1986).

Despite Congress's conviction that the cycle meter reading method was improper and would not be permitted in the future, the cycle meter reading method was approved for past years in order to minimize disputes, but Congress stated no inference was intended as to the bills issued method of accounting.

Therefore, the Service should continue litigating the bills issued aspect of the unbilled revenue issue. Under a strict accrual method of accounting, income is to be included in gross income for the taxable year in which all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.451-1(a).

The "all events" requirement is satisfied with respect to income when payment is due, when payment is received, or when the income is earned, whichever occurs first. A corollary of this rule is that the "all events" requirement is satisfied no later than the time when income is earned by performance, regardless of when billing is permitted. Treas. Reg. § 1.446-1(c)(1)(ii); Bentley Laboratories v. Commissioner, 77 T.C. 152 (1981). Furthermore, even if the utilities in Orange and Rockland were considered to be furnishing services, instead of goods, there would be no difference in the outcome, because the governing rule for service providers also requires accrual of reasonably estimatable income no later than the time when the income is earned, irrespective of the time when billing is permitted. The date when billing occurs, or is permitted, is relevant in determining whether a right to income is fixed only in cases where the income has not yet been earned through the

performance of services or delivery of goods. See Schlude v. Commissioner, 372 U.S. 128 (1963). Accordingly, it is our litigating position that income is properly accruable as of the time the utility services are provided, and the billing date is irrelevant.

Even in Orange and Rockland, supra, the court held:

> We distinguish the event which renders services as billable from the mere ministerial act of billing. We note that under Accounting Principles Board, Statement No. 4, revenue from services rendered is recognized when services have been performed and are billable.... [T]he occurrence of the respective cycle meter reading date in January is the critical event necessary to fix petitioner's right to unbilled December revenue and renders such services billable. Billing is purely a ministerial act which has no effect on petitioners' revenue recognition treatment.
> 86 T.C. at 214.

Therefore, it is our opinion that based on the Conference Report the bills issued method is not acceptable for taxable years prior to August 16, 1986, unlike the specific approval which was given to the cycle meter reading method. We recognize, though, the possibility that a court, if faced with a pre-August 16, 1986, taxable year and fragmented meter reading and billing cycles with accrual of income based on bills issued, may approve accrual based on the cycle meter reading method rather than requiring accrual of the unbilled revenues through year-end. The court would in effect be allowing the taxpayer to benefit from the Conference Report's approval of taking income into account on the basis of meter readings for years prior to August 16, 1986, notwithstanding that the taxpayer was accruing income based on bills issued.

2. If a taxpayer offers to change its method of accounting to report revenues on the basis of a meter reading in the context of issue 1 above, it is a policy decision whether to approve such a change.

As a legal matter, the Service is not required by section 451(f) or the conference report (H.R. Rep. No. 841) to approve a change in accounting method from the bills issued method to the

cycle meter reading method. The bill (Pub. L. No. 99-514, § 821(b)(2)) treats any change in the method of accounting required by the provision as a change in the taxpayer's method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury. See section 446(e) and Treas. Reg. § 1.446-1(e). Section 451(f) requires the taxpayer to report income under an accrual method of accounting, and prohibits use of the meter reading or bills issued methods of accounting.

The conference report and section 821(b)(3) of the Act allows the use of the meter reading method in order to minimize disputes over prior taxable years. It is Service position that the law approves the use of the meter reading method for taxable years prior to August, 16, 1986, but does not allow others to obtain the benefit of the provision by adopting that method now. This is clear from the language used: "for any taxable year beginning before August 16, 1986, a method of accounting which took into account income..."[Emphasis added.] A current change in method of accounting would not be one "which took" such income into account prior to August 16, 1986.

However, as mentioned under issue 1, one of the risks of pursuing the "unbilled revenue" issue for taxpayers using the bills issued method is that a court might switch taxpayers to the cycle meter reading method. If such a change is not voluntarily allowed by the Service upon taxpayers' request, and the courts determine it should be permitted, there may be a policy issue (as discussed infra, issue 3) of whether the Service is encouraging people not to settle disputed issues.

Because the utility industry is so closely knit, a uniform, consistent position must be developed for this issue. Decisions about whether a taxpayer can change its method of accounting from the bills issued method to the meter reading method can not be approved on a case by case basis. The position to be taken with regard to the entire utility industry is a policy decision which should be made under the auspices of the Industry Specialization Program.

3. We recommend not approving a claim or a change of accounting application to report revenues on the basis of meter readings where the taxpayer has previously agreed to change its method of accounting to report unbilled revenues.

We recognize that a taxpayer who previously agreed to accrue unbilled revenue would not come under the special relief provided by Congress for taxable years prior to August 16, 1986, for the use of the cycle meter reading method. If the Service allowed a taxpayer to change its method of accounting again in an effort to obtain the benefits of the exception in the legislation, it would have an adverse effect on the settlement process. In order for settlements to be final and conclusive, the Service would always have to enter into closing agreements. Any time a taxpayer settles an issue, there is a risk that another taxpayer will obtain a more favorable settlement or

litigate and win the same issue. Therefore, it is our recommendation that a taxpayer not be allowed to rescind a previous agreement to accrue unbilled revenues but rather should be required to abide by a previous settlement with all its attendant risks.

When a taxpayer offers to waive the restrictions on assessment and collection of deficiency in tax (Form 870-AD), the Form states that if the Commissioner accepts the offer, "the case shall not be reopened in the absence of fraud, malfeasance, concealment or misrepresentation of material fact." This is very close to the finality of closing agreements. Section 7121(b) provides that if the closing agreement is accepted by the Secretary, "such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact-(1) the case shall not be reopened as to matters agreed upon..." A change in legislation is not fraudulent, malfeasant or a misrepresentation of material fact. Therefore, the settlement should remain binding.

Congress recognized the cycle meter reading method as an improper method of accounting, and permitted its use for prior years only in order to minimize disputes with the Service. There is no apparent legislative intent that a taxpayer who voluntarily abandoned an improper method of reporting revenues now be permitted to get the benefit of returning to such improper method.

4. <u>If a taxpayer accrues income on the bills issued method, not the cycle meter reading method, the Service should continue to raise the "budget billing" issue to the extent that energy was delivered between a meter reading and the end of the year and payment was received.</u>

The answer to the "budget billing" issue depends on whether the taxpayer is basing the accrual of utility revenues on meter readings or on bills issued. If the accrual is based on cycle meter readings, the taxpayer comes within the exception created by the law for taxable years prior to August 16, 1986. If the accrual is based on bills issued, the exception would not be applicable.

The Service position regarding budget billing is summarized in Rev. Rul. 72-114, 1972-1 C.B. 124. The Revenue Ruling provides that where a taxpayer uses a monthly "budget billing" procedure:

> [T]he taxpayer must accrue as income,...the monthly charges for gas actually consumed either computed on the basis of a meter reading during the

> taxable year or, for months subsequent to the last meter reading, by estimating the monthly charge. In addition, the taxpayer must accrue as income for such taxable year any excess of the amount of the budget-billings during such year over the monthly charges accruable for such year under the preceding sentence, to the extent such excess is attributable to the reasonably estimated charges for gas distributed through the last month of such year.

In Bay State Gas Co. v. Commissioner, 689 F.2d 1 (1st Cir. 1982), the court held it was an abuse of discretion for the Internal Revenue Service to require an accrual basis public utility, which used a cycle meter reading method of accounting, to accrue as income for the current year charges allocable to gas consumed by its budget billing customers between the last meter reading date in December and December 31, unless the gas actually consumed had been paid for before the year-end. The court found there was no meaningful distinction between the utility company's regular customers and its budget billing customers. Therefore, there was no basis for saying that normally accruable late December sales need not be accrued as to regular customers, but need be accrued as to budget billing customers. 689 F.2d at 5-6.

Congress's approval of the cycle meter reading method for pre-August 16, 1986 taxable years should apply to budget billing customers. But if accrual for the budget billing customers is based upon the bills issued method, we believe that the issue may be raised to the extent of energy delivered through year-end.

5. We recommend not approving a claim or a new change of accounting application which would eliminate the revenues which the taxpayer reported when it agreed to change its method of accounting to report budget billing in accordance with Revenue Ruling 72-114.

The same considerations discussed in issue 3 also pertain to this policy decision. Due regard must be given to the possibility that such approvals could be encouraging people not to settle as well as weakening the conclusive effect of settlement agreements. Please refer to the response to issue 3.

6. The Service should continue to raise the "customer deposit" issue.

The provision in the Tax Reform Act of 1986 regarding unbilled revenue has no impact on the customer deposit issue. It is irrelevant whether the utility company is or has been using a strict accrual, cycle meter reading or bills issued method of accounting.

The Service continues to adhere to its position in City Gas Co. of Florida v. Commissioner, 689 F.2d 943 (11th Cir. 1982), on rem'd, T.C.M. 1984-44 and in Gas Light Co.of Columbus v. Commissioner, T.C.M. 1986-118. Such amounts are an advance payment securing the receipt of future income and must be included in the utility company's gross income.

The court found in City Gas Co. of Florida v. Commissioner, supra, that where a taxpayer receives advance payment for goods or services or other income items over which the taxpayer has present right and complete and unrestricted control, advance payment constitutes "income," and such payments are taxable even though a refund may be required under certain circumstances. 689 F.2d at 945-46. In cases in which the purpose of the "deposit" payment to the taxpayer is a mixed purpose of providing both payment for income items and to secure performance of nonincome-producing covenants, taxation of such payments must turn on the circumstances of the transaction and the intent of the parties; if the primary purpose of the payment is to act as prepayment for goods and services, then the full amount constitutes taxable income, but if the primary purpose is to secure performance of nonincome-producing covenants or to secure against damage to property, then the payment is not taxable. Id. at 946. Upon applying the primary purpose test, the Tax Court, on remand, found the primary purpose of customer deposits was as advance payment for the gas consumed. 47 T.C.M. at 973-74.

It makes no difference what method of accounting the utility company has been using to recognize income from the sale or furnishing of utility services if the primary purpose of customer deposits is as advance payment for utility services. Any change in the method of accounting will not alter this characterization of the customer deposits.

There is one interesting development regarding the characterization of utility "services". The Service position is that gas, electricity and water are inventoriable goods. As the Tax Court held in City Gas Co., supra, and Gas Light Co. of Columbus, supra, in the context of an advance deposit issue, natural gas held by a public utility for sale to customers in the ordinary course of its trade or business was a good. The proposition that gas is a good is further supported by the fact that it is includable in inventory. See, e.g., Las Cruces Oil Co., Inc. v. Commissioner, 62 T.C. 764 (1974); Northern Natural Gas Co. v. Commissioner, 44 T.C. 74 (1965), aff'd, 362 F.2d 781 (8th Cir. 1966).

Because gas, electricity and water are inventoriable goods, they come under the provisions of Treas. Reg. § 1.451-5(c)(1). Section 1.451-5(c)(1) provides that if a taxpayer receives "substantial" advance payments with respect to an agreement for the sale of goods properly includible in his inventory and has on hand goods in sufficient quantity to satisfy the agreement in such year, then all advance payments received with respect to such agreement by the last day of the second taxable year following the year in which such substantial advance payments are received and not previously included in income in accordance with the taxpayer's accrual method of accounting, must be included in such second taxable year. Therefore, as held in City Gas Co., 47 T.C.M. at 975, the customer deposits would be includible in income by the second year following receipt.

However, the Tax Court in Orange and Rockland, 86 T.C. at 214, held the delivery of natural gas constituted a service rather than the sale of a good. And in section 451(f), Congress also referred to "income attributable to the sale or furnishing of utility services to customers..." If regarded as advance payment for services, the deposits would be treated according to the provisions of Rev. Proc. 71-21, 1971-2 C.B. 549. Rev. Proc. 71-21 would require the inclusion of the deposits in the utility company's income in the year of receipt since a portion of the services would be performed by it at an unspecified future date which might be after the end of the taxable year immediately succeeding the year of receipt.

It is unlikely that the utility companies will argue that gas and oil should be regarded as a service since they would therefore have to include the customer deposits in their income at an earlier date. In this regard, the Service position that gas, electricity and water are inventoriable goods is favorable to the utility companies.

-- Since the furnishing of electricity, water and gas are deemed by the Service to be the provision of inventoriable goods, they are allowed the reporting deferral provided by Treas. Reg. § 1.451-5(c)(1)(i). The method of accounting which the utility company uses has no effect on the Service's position on when customer deposits should be taken into income.

7. The Service should not allow a taxpayer, who has previously agreed to change its method of accounting to report customer deposits in income as advance payments and now files a claim or a request for a change in accounting method, to exclude these advance payments.

It is our opinion that the new law has no effect on the Service's position with regard to the customer deposit issue. Advance payments and the customer deposit issue are separate and distinct from the "unbilled revenue" issue. See the response to issue 6.

If you have any questions concerning this matter, please contact Helen F. Rogers at FTS 566-4189.

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